GOVERNOR'S BLUE RIBBON COMMISSION ON PUBLIC EMPLOYEES RETIREMENT SYSTEMS
MINUTES
May 14, 2007

The Governor's Blue Ribbon Commission on Public Employees Retirement Systems was called to order by Chairman John Farris, Secretary, Finance and Administration Cabinet, on Monday, May 14, 2007 at 1:00 p.m. in Room 129 of the Capitol Annex. Chairman Farris noted for the members that the press had been notified of the meeting.

Other members present were Lt. Colonel Shelby Lawson, proxy for Jack Adams, Commissioner, Kentucky State Police; Mark Birdwhistell, Secretary, Cabinet for Health and Family Services; Robert Brown, Executive Director, Kentucky Public Employees Deferred Compensation Authority; Brad Cowgill, State Budget Director; Brian Crall, Secretary, Personnel Cabinet; David G. Dowell, gubernatorial appointee; John Hall, gubernatorial appointee; William P. Hanes, Executive Director, Kentucky Retirement Systems; Gary Harbin, Executive Secretary, Kentucky Teachers' Retirement System; Frank Hatfield, designee for Kentucky Retired Teachers Association; Lee Jackson, President, Kentucky Association of State Employees; Andrew Jacobs, gubernatorial appointee; David Jones, gubernatorial appointee; Sylvia Lovely, Executive Director, Kentucky League of Cities; Brent McKim, designee for Kentucky Education Association; Representative Robin Webb proxy for Representative Harry Moberly, Chairman, House Appropriations and Revenue Committee; Ronnie O'Nan, Executive Director, Kentucky Transportation Employees Association; James Parsons, gubernatorial appointee; Ryan Bridgeman, proxy for Shawn Ridley, gubernatorial appointee; Debra Tudor, gubernatorial appointee; and Todd Lowe, gubernatorial appointee. Representative Harry Moberly arrived after the meeting convened.

Chairman Farris declared a quorum was present and asked for a motion to approve the minutes of the April 16, 2007 meeting. A motion was made and seconded to approve the minutes of the April 16, 2007 meeting. Motion carried.

Chairman Farris stated that Mike Burnside, Deputy Secretary, Finance and Administration Cabinet and Fran Pinkston, Executive Director, Office of Material and Procurement Services, Finance and Administration Cabinet, would discuss the Request for Proposals (RFP) for consultants to the Commission.

Deputy Secretary Burnside stated that both RFPs were active and that Ms. Pinkston would update the members on both RFPs. He reminded the members that any questions regarding the procurement of services or the process should be directed to Ms. Pinkston.

Ms. Pinkston stated that the RFP for legal consulting services was issued on April 23, 2007. She indicated that responses to the RFP were due by COB on Tuesday, May 15, 2007. Ms. Pinkston stated that the RFP for actuarial and benefits services was issued on May 8, 2007 with responses due on May 30, 2007.

Chairman Farris stated that he anticipates that the contract for legal services will be awarded before the next meeting and the winning firm will be invited to attend the meeting to describe the scope of their work. Chairman Farris added the actuarial consultant will be invited in July to give a presentation on the scope of their work. He noted that both consultants will be available to the working groups.

Sylvia Lovely asked how the consultants were selected. Chairman Farris indicated that the consultants were selected on a best value basis (price and qualifications) by a team of merit and non-merit employees who score the responses. Chairman Farris stated that the bidder with the highest score is awarded the contract. Ms. Lovely asked if the members of the committee were employees of the state. Chairman Farris stated that was correct and that Mr. Hanes and Mr. Harbin will serve on the selection committees. Ms. Lovely asked how the field that received the RFPs was selected. Chairman Farris stated that the RFPs were posted on the Material and Procurement Services Web site and the RFPs are sent to individual firms qualified to perform the requested services and who are registered to do business with the Commonwealth.

Ms. Pinkston added that the system used by the Office of Material and Procurement Services sends e-mails to vendors who register by certain commodities. She continued that over 1,200 e-mails were sent to vendors for legal services and over 700 for the actuarial services.

Chairman Farris asked the working groups to give an update on their progress since the last meeting.

Brad Cowgill stated that Working Group 1 (Funding Liabilities) plans to meet during the week of May 28, 2007.

Secretary Crall indicated that Working Group 2 (Pensions) held an organizational meeting on May 2, 2007. Secretary Crall stated that it was decided to add Mr. Hanes and Mr. Harbin to the RFP selection committees. He stated that the group also discussed what level of income replacement would drive the working group's review of the benefit compensation. Secretary Crall said minutes of the meeting would be available to the Finance team today to place on the Web site.

Secretary Birdwhistell stated that Working Group 3 (Health Insurance) met on May 7, 2007. He indicated that the work group was presented information on the purpose and charge for the group and received an in-depth briefing from Jane Gilbert, Kentucky Teachers' Retirement System (KTRS), on benefit and plan design regarding the over 65 retirees in KTRS and Humana Medicare Advantage Private Fee for Service Plan, which became available in January 2007. Secretary Birdwhistell stated that the working group is scheduled to meet on June 4, 2007 at which time the group will have a brief overview of the Medicare Modernization Act and how recent federal legislation affects retirement health benefits. Secretary Birdwhistell stated that the group will also be briefed by a representative of the Kentucky Employees Retirement System

(KERS) who will present a comparison in benefits, plan design and utilization of KERS, the County Employees Retirement System and the State Police Retirement System. He added that this information will be compared to the active employees currently receiving benefits under the Kentucky Employees Health Benefit Plan for each of the groups.

Chairman Farris introduced William P. Hanes, Executive Director of the Kentucky Retirement Systems, who presented an overview of the structure of the Kentucky Retirement Systems. A summary of the presentation follows:

> KRS administers retirement benefits for the Kentucky Employees Retirement System, the County Employees Retirement System and the State Police Retirement System. The systems are overseen by a nine-member board comprised of trustees elected by the members of the three systems, three appointed by the Governor, and the Secretary of the Personnel Cabinet, who serves as an ex-officio member. Total membership (retired, inactive and active) at June 30, 2006 was 302,297 members. As of March 31, 2007, KRS assets were $16.43 billion and liabilities were $1.3 billion in pension and health insurance benefits. The three systems are Qualified Public Defined Benefit Plans established under Section 401a of the Internal Revenue Code and pay benefits on a formula as opposed to a defined contribution plan, which pays benefits based on contributions and the earning of those contributions. The annual benefit is computed by multiplying an employee's final compensation by the statutory benefit factor (2.0, 2.2, etc) and the employee's years of service. For employees who retire with 20 or more years of service, 100 percent of the monthly contribution for health insurance will be paid. Employees (non-hazardous) injured in the line of duty may receive full payment on health insurance with one month of service. Hazardous members disabled in the line of duty, notwithstanding the service credit, receive full health benefits for the family. KRS is funded through employee contributions set by statute; employer contributions set annually by the KRS Board of Trustees based on an actuarial valuation; and return on investments. In 1978, the General Assembly created the insurance contribution for retirees and in 1988 an amendment made health insurance a contractual obligation. In 2006, the Governmental Accounting Standards Board (GASB) issued Statement 43 and Statement 45, which changed the accounting and reporting requirements related to Other Post Employment Benefits (OPEB) for public retirement systems. Changes in the way benefits were reported have caused KRS to report on an accrual basis the cost of retiree health insurance benefits over the life of the employee. KRS investment income represents 64 percent of the revenue available to pay benefits. KRS investments have consistently met or exceeded performance benchmarks for the Pension and Insurance Funds. Funding level is the ratio of actuarial assets to actuarial liabilities and is a measure of the plan's financial soundness. Unfunded actuarial liability is the difference between actuarial value of assets and liabilities

and represents liabilities on benefits already earned by employees and retirees. It is amortized over a 30-year period and the amortization payment is a part of the employer contribution rate. Total unfunded liability in KERS increased from $4.57 billion in 2005 to $11.93 billion in 2006. The primary reason for the dramatic increase is OPEB with GASB 43/45. Historical reductions in employer contributions and investment income shortfall: cost inflation for retiree insurance; GASB 43/45; benefit enhancements; retiree Cost of Living Adjustment (COLA) increases not pre-funded; and market losses in 2000-2002 have contributed to an increase in unfunded liabilities. Since 1990, various benefit enhancements have been added including: a change in non-hazardous benefit factor from 2.0 to 2.2 percent (CERS only); 27 years and out for non-hazardous employees; school board participation requirements reduced to 80 hours per month; COLA with no prefunding; high-three window for KERS and CERS non-hazardous and CERS Hazardous; and KERS 2.20 benefit factor with 20 years of service. The retirement allowance is automatically increased each July unless the General Assembly reduces or eliminates the COLA, which is not guaranteed by the inviolable contract. Pension rates are increasing because of the COLA. The actuary reported in March 2007 that each COLA generates a negative cash flow followed by a positive cash flow later, which means fewer dollars to invest currently, lower investment returns and higher employer costs over the long term. In 2003, the KRS Board completed a full review and offered several options for employees. Some of these options for new hires were implemented into law by HB 290 of the 2004 General Assembly. Savings were estimated to amount to $2.25 billion over a 20-year period. In 2004, employees hired on or after July 1, 2003 earn health insurance benefits based on dollar value: non-hazardous, $10 a month for each year of actual service and hazardous, $15 month for each year of actual service. Purchases made after August 1, 2004, do not count toward vesting for health insurance benefits; will not count toward vesting for retirement eligibility; and purchase factor methodology was amended in 2005.

The following questions regarding the presentation were raised:

1. Regarding Slide 13 -- KRS Health Insurance Benefits for Members Participating Prior to July 1, 2003. Sylvia Lovely asked if 100 percent coverage for dependents would continue after the death of the employee. Mr. Hanes stated that as long as the member chooses a benefit that creates a survivorship for the spouse, payments and coverage would continue. Ms. Lovely asked if there would be a supplement after the survivor reached Medicare age. Mr. Hanes stated that when the dependent becomes Medicare eligible a supplement is administered by the Kentucky Retirement System. Ms. Lovely asked if the employee benefit was reduced if the employee elected the survivor benefit. Mr. Hanes stated that when an employee chooses a survivorship, all the options are derived from the highest option (full-life annuity). If a hazardous member chooses a

survivorship, health insurance is applicable to that spouse as long as he/she draws the benefit.

2. Regarding Slide 20 -- Actuarially Recommended 2006 Employer Contributions. Chairman Farris asked Mr. Hanes to explain how the contribution works for the employer. Mr. Hanes stated that employers are billed for contributions that the Board assigns to the agency and the funds are deposited into a trust. He further stated KERS hazardous and non-hazardous and SPRS employer contributions are a function of the legislature and are appropriated through the budget process. Mr. Hanes stated that CERS must pay the prescribed rate. He further added that the Combined Recommended Rate is above what the employee is paid.

3. Regarding Slide 20 -- Actuarially Recommended 2006 Employer Contributions. Sylvia Lovely asked Mr. Hanes to explain the reason why the unfunded liability for the cities and counties is smaller than other systems. Mr. Hanes stated that the health insurance component is one of the reasons the unfunded liability is smaller. He further stated that KRS has the benefit of all of the contribution and there is no loss when paying the full contribution. Mr. Hanes said the other factor is that the makeup of CERS is mostly state agencies. He pointed out that the health insurance benefit is assessed per person as a percentage of salary. The average non-certified school board salary is much less than other non-school board CERS employees.

4. Regarding Slide 20 -- Actuarially Recommended 2006 Employer Contributions. Brent McKim asked how much of the insurance fund percentages were for individuals between retirement age and age 65 when Medicare would be available and how much of the insurance fund percentages were a result of the expense from supplemental Medicare coverage. Mr. Hanes indicated that KRS did not have that information broken down but could ask the actuary if it was possible to get that information .

5. Regarding Slide 20 -- Actuarially Recommended 2006 Employer Contributions. Brad Cowgill asked Mr. Hanes to confirm no health insurance costs are included in normal costs. Mr. Hanes stated normal costs do not include health insurance costs. Mr. Cowgill asked if payment on unfunded actuarial liability included health insurance costs. Mr. Hanes stated that unfunded actuarial liability did not include health insurance costs. Mr. Cowgill asked if administrative expense included health and pension costs. Mr. Hanes stated that column (Administrative Expense) included pension and health costs. Mr. Cowgill asked it would be possible to divide the insurance fund figure to reflect the normal cost of the insurance fund and the payment against unfunded actuarial liability for health insurance. Mr. Hanes stated that would be possible. Mr. Cowgill asked if it would be possible to separate the administrative expense to reflect pension and insurance costs. Mr. Hanes stated that it would be possible. Mr. Cowgill stated that assuming the figures in the insurance fund are a combined normal cost and unfunded liability for insurance,

would it be possible to determine what is covered by the inviolable contract in order to make the calculation of the unfunded liability portion of the insurance fund. Mr. Hanes stated he did not think it would be possible. Mr. Cowgill stated that when looking at the pension plan, the payments against the unfunded liability are significantly higher (KERS non-hazardous) than the normal cost. Mr. Cowgill asked if the unfunded liability is significantly higher than the normal cost of health insurance. Mr. Hanes stated he would think so. Mr. Hanes stated that this was related to the GASB/OPEB issue because it creates more of an unfunded liability for the health insurance because all the liability has to be reported as it is accrued. Mr. Hanes stated he would prepare information for the members.

6. Regarding Slide 20 -- Actuarially Recommended 2006 Employer Contributions. Brent McKim asked how much of the insurance expense comes from the interim between retirement and Medicare and how much of it comes as a result of the supplement. Mr. McKim asked if a significant amount is being spent on health insurance, was there a way to have what is being spent reflected on a pie chart. Mr. Hanes indicated he felt it was possible to get that information.

7. Regarding Slide 20 -- Actuarially Recommended 2006 Employer Contributions. Mark Birdwhistell asked Mr. Hanes to explain why the insurance fund for CERS was lower than the other systems. Mr. Hanes stated that the reason is two-fold. He stated that the unfunded liability is less to begin with: GASB applies only to health insurance (OPEB portion); and the liabilities and the discount rate to determine those liabilities must best represent what the true liabilities are. Mr. Hanes stated that the actuary, following GASB rules, determined that there must be a mixed rate. KERS non-hazardous and SPRS use a blended rate of 4.5 percent and the other systems use a rate of 7.75 percent, which is a direct result of historical shortfalls of the contributions. Secretary Birdwhistell asked what the portion that is actually real interest cost is based on. Mr. Hanes stated that GASB only applies to health insurance costs. He further stated that GASB is a reporting requirement for health insurance for retirees.

8. Regarding Slide 20 -- Actuarially Recommended 2006 Employer Contributions. John Hall asked if the recommended combined rate was for 2006. Mr. Hanes stated that the rate is based on a June 30, 2006 actuarial valuation and is the rate for the following July. He stated that each year the actuary determines the loses or gains based on economic and demographic assumptions (i.e. losses on investments, increased disability payments or increased retirements). Mr. Hall asked if the unfunded liability was part of the rate. Mr. Hanes stated the rate was a one-year employer contribution rate.

9. Regarding Slide 20 -- Actuarially Recommended 2006 Employer Contributions. Brent McKim stated that he understood that CERS employees (counties and cities) do not have the option not to pay the full amount. He asked if this was the reason why the insurance

fund for CERS was lower than for KERS. Mr. Hanes stated that CERS employees were paying the full contribution, which put them in a better funding position.

10. Regarding Slide 20 -- Actuarially Recommended 2006 Employer Contributions. Jim Parsons asked a question that was inaudible.

11. Regarding Slide 20 -- Actuarially Recommended 2006 Employer Contributions. Representative Robin Webb asked why the SPRS combined recommended rate was much higher than KERS and CERS. Mr. Hanes stated that SPRS is a small system with greater liability. He further stated that GASB requires KRS to use a rate of 4.5 percent, which creates much of the spike in the combined recommended rate.

12. Regarding Slide 20 -- Actuarially Recommended 2006 Employer Contributions. Jim Parsons asked what the unfunded liability in the state system would be had the legislature funded what the actuary recommended. Mr. Hanes stated he did not have that information, but he would make it available to the members.

13. Regarding Slide 21 -- Actual versus Recommended FY 2006-2007 Employer Contributions. Jim Parsons commented that it might be helpful to see comparisons for past years showing what the actuary recommended versus what the state paid. Mr. Hanes stated that information was shown in the historical reductions to the employer contribution rates on Page 40 of the presentation.

14. Regarding Slide 21 -- Actual versus Recommended FY 2006-2007 Employer Contributions. John Hall stated that the actual contribution paid for KERS non-hazardous was much less than the recommended rate for KERS hazardous, CERS and SPRS. Secretary Farris stated that the KRS Board recommends a rate to the legislature and in this particular year in the budget a lower rate of funding was approved. Mr. Hanes stated that the General Assembly has the authority to appropriate and CERS agencies do not. He continued that when the KRS Board prescribes the rate, the legislature may choose to pay something less, but with CERS they have no opportunity to pay anything but the rate prescribed by the Board.

15. Regarding Slide 22 -- Investment Performance. Sylvia Lovely asked if Strategic Investment Solutions (SIS) was the entity that actually invests for KRS. Mr. Hanes stated that SIS was the investment consultant for KRS. He pointed out that CEM Benchmarking, Inc. is an independent consultant not employed by KRS.

16. Regarding Slide 22 -- Investment Performance. Lee Jackson stated that according to the information presented, KRS has consistently met or exceeded the benchmarks. He asked if the KRS Board could set higher or lower benchmarks and if so, would KRS be required to meet those benchmarks. Mr. Hanes stated that the benchmarks are self-imposed

indexes based on the class of the assets, which is how you measure your success in performance. Mr. Jackson stated then that the argument that KRS has not kept pace with other states or other systems investment wide is not a valid argument. Mr. Hanes stated that KRS is a complex system compared to others and the portfolio must reflect KRS's system and the long-term approach to satisfying the liabilities. He pointed out that KRS has a liability stream to identify costs and a strategy must be developed with investment consultants to satisfy the liability stream.

17. Regarding Slide 26 -- Actuarial Basics. Brad Cowgill asked Mr. Hanes to explain actuarial versus market value. Mr. Hanes stated that market value is the fair market value of the total portfolio at a particular time. He stated that the actuarial value is fluctuating on a five year basis. Mr. Cowgill asked if each percentage started out as a fraction with the assets in the numerator and the liabilities in the denominator. Mr. Hanes stated the assets are valued on a market or actuarial basis. Mr. Cowgill asked if the denominator included unfunded actuarial accrued liabilities as well as normal costs. Mr. Hanes indicated that the denominator included only the actuarial unfunded liability. Mr. Cowgill asked if rather than percentages, if the fraction were shown, it would be representative of what was thought to be the liabilities in 2001 or what they actually were. Mr. Hanes indicated that the fraction would represent what the liabilities were. Mr. Cowgill asked if, over the course of the seven years, the value of the assets in the numerator increased, was there an actual increase in the denominator. Mr. Hanes stated that the numerator decreased when the market value decreased.

18. Regarding Slide 26 -- Actuarial Basics. David Dowell asked if the biggest hole in the unfunded liability was a result of underperforming assets because of market conditions or from under funding by the legislature. Mr. Hanes stated that if you are only looking at the pension portion that was correct.

19. Regarding Slide 22 -- Investment Performance. Brent McKim asked if the funding level dropped from 120 percent to 60 percent, do you have less assets to grow to maintain the 64 percent shown in Slide 16 and do you become more reliant on other assets for growth. Mr. Hanes stated that as your asset base is reduced you become more reliant on both employee and employer contributions.

20. Regarding Slide 44 -- Cost Inflation for Retiree Insurance. David Dowell asked why there was deflation (-6.34 percent) in the KRS Medicare Eligible group in 2006. Mr. Hanes stated that KRS does not administer health insurance benefits to the non-Medicare group and deferred to Brian Crall for a response. Secretary Crall stated that in 2004, in anticipation of rising costs, there was a recommendation based on available funds to adjust benefits that ultimately were altered by the General Assembly in a Special Session. He further stated that the net effect was to deposit an additional $200 million into the benefit system, which resulted in a tremendous increase to the agencies and caused the

spike in 2005. Secretary Crall pointed out that since that time, the state plan is fully self funded and the trends have decreased dramatically. Secretary Crall stated that the benefits employees receive today are not necessarily the same benefits or at the same benefit levels employees received previously. Mr. Dowell noted that there has been some escalation of benefits in 2003 and asked if employees hired after that date received lesser benefits than those who received increased benefits over the years. Mr. Hanes stated that there had been a substantial reduction in benefits for employees hired after 2003.

21. Regarding Slide 44 -- Cost of Inflation for Retiree Insurance. Sylvia Lovely asked if the crisis for CERS was the next 20 years because cities and counties pay their bills on time. Mr. Hanes stated that that crisis exists for all systems for a variety of reasons. If you take total liabilities and divide it between employees and retirees, retirees make up over 50 percent of the vested population.

22. Regarding Slide 44 -- Cost of Inflation for Retiree Insurance. Brad Cowgill asked Mr. Hanes to explain the 50 percent figure. Mr. Hanes stated that when considering total liabilities of vested retirees and employees, retirees make up over 50 percent of the liability.

23. Regarding Slide 44 -- Cost of Inflation for Retiree Insurance. Brent McKim asked if KRS was responsible for paying the full cost of the single plan for retirees in the state group or if there is any underwriting. Mr. Hanes stated that because of the inviolable contract, the state will always be responsible for the cost. He added that pension trust monies are available to pay those benefits and that contributions and investment earnings on the trust money will be paying for the full benefit of health insurance. Mr. McKim asked if the 2005 figure for the State Group Single Plan represents an average increase of 43.36 percent. Mr. Hanes stated that was correct. Secretary Crall pointed out there are three levels of coverage and that KRS has chosen to pay for coverage in the Enhanced (middle) tier.

24. Regarding Slide 48-- GASB 43/45. Representative Moberly asked if the unfunded liability was shown without GASB requirements. Mr. Hanes said it was not a part of the presentation, but he would have it available for the members. Mr. Hanes agreed that there is no federal or state law that requires KRS to be in compliance. He noted that GASB 43/45 is a "best-practice" requirement that rating agencies expect agencies to follow. Representative Moberly asked if there was an actual standard GASB set forth that indicates KRS is in good standing or that KRS has appropriately funded its unfunded liability. Mr. Hanes indicated that GASB 43/45 is a relatively new statement and KRS is constantly trying to get more guidance in how to comply. Representative Moberly stated that he would like to see the unfunded liability without the GASB requirement. Mr. Hanes stated that information could be provided.

25. Regarding Slide 54 -- Impact of the July 1, 2006 COLA. Representative Moberly pointed out that the KTRS COLA is statutorily 1.5 percent and any adjustment above that 1.5 percent is pre-funded by the General Assembly. He stated that if KERS provided equity it would help to resolve the problem with the KERS COLA.

26. Regarding Slide 7 -- Plan Type. Lee Jackson asked Mr. Hanes if he believed the defined benefit plan is more efficient than the defined contribution plan. Mr. Hanes stated that he believed the defined benefit plan was more efficient. Mr. Hanes stated that policy issues will need to be addressed when consideration is being given to leaving public employees without a sustainable income.

After a short break, the meeting reconvened. Chairman Farris stated that Representative Harry Moberly would like to address the Commission.

Representative Moberly stated that the General Assembly has never enacted a contribution rate that was less than what was recommended by Executive Branch or the State Budget Director.

Chairman Farris introduced Gary L. Harbin, CPA and Executive Secretary of the Kentucky Teachers' Retirement System (KTRS), who presented an overview of the structure of KTRS. A summary of the presentation follows:

> KTRS was established by the General Assembly in 1938 and funded in 1940. The current employers of KTRS include 175 local school districts, 17 Department of Education agencies, five regional universities and all community colleges and KCTCS. Most of the members of KTRS are not subject to social security. KTRS has had a fixed employer contribution rate since inception. Health benefits for retirees are provided on a pay-as-you-go basis and are not part of the inviolable contract for teachers. COLAs are prefunded at a base of 1.5 percent with any additional amount awarded by the General Assembly in the biennial budget process. KTRS provides benefits to members if the member becomes disabled while working, to survivors in the event of the member's death and a life insurance benefit of $2,000. KTRS provides its retired members with lifetime guaranteed retirement benefits, a life insurance benefit of $5,000, an annual COLA of 1.5 percent and medical benefits. The cost of administration for the KTRS pension plan is five basis points and the cost of investments is four basis points, approximately $13 million per year. The calculation of retirement benefits is years of service x multiplier x 5 highest salaries. The multiplier was changed in 2002 for new hires from a flat 2.5 percent to a stair step approach: a 2.0 multiplier for the first 10 years of service; a 2.5 multiplier upon achieving 10 years of service; and a 3.0 multiplier added for all members that teach longer than 30 years (31 and above). In addition, the high three salaries at age 55 with 27 years of service enters into the benefit formula. The formula is substantially discounted if

an employee has fewer than 27 years of service but is at least age 55. As of December 2006, KTRS had 44,269 full-time members who were not eligible to retire; 14,004 members eligible to retire; 15,042 part-time members; 16,642 inactive members; and 39,332 retired members and beneficiaries for a total of 129,289 members. As of June 30, 2006, the actuarial value of the assets was $14.8 billion, the liabilities were $20.3 billion and the unfunded liabilities were $5.5 billion. The pay-as-you-go medical benefit has been in existence since 1964, is not a pre-funded benefit and is not part of the inviolable contract. The base funding for the medical benefit, which covers about 30-40 percent of the cost, is 3/4 of 1 percent for the member contribution matched by the state for a total of 1.5 percent of payroll. To continue funding through 2008, the Commonwealth must borrow $289 million from the KTRS pension fund to fund benefits through this biennium. There is a need for the medical insurance funding to be included in the General Fund in lieu of borrowing from the pension fund to maintain the financial viability of the fund. The funding level has changed due to an increase in the number of employees who are retired and the level of the cost of medical coverage. In 1998, the base contribution of the medical insurance benefit was not sufficient to keep up with increases in cost and a portion of pension contributions were directed into the medical plan to pay benefits. In 2004-2005, the actuary determined that the funding for the medical plan could not continue to erode the pension plan without affecting the actuarial soundness of the system. At this time, the state began to borrow the amounts from the pension fund with an agreement to pay the funds back within 10 years at an actuarial assumed rate of return of 7.75 percent. KTRS is actuarially sound, but borrowing from the pension fund should cease. A recent actuarial report revealed that KRTS should increase the employer contribution (in the 2008 Regular Session) from the currently funded 1.32 percent to 1.88 percent. The non-university contribution rates for employee/employer are 9.855 percent for employee and 13.105 percent for employer. The university contribution rates for employee/employer are 8.375 percent for employee and 11.625 percent for employer. KTRS is currently reviewing health benefits for retirees. Health benefits are provided to retirees through the Kentucky Employees Health Plan for employees under age 65 and the Medicare Eligible Health Plan for retirees age 65 and older. The Kentucky Employees Health Plan includes school district employees; state employees; some local government employees, teacher retirees under age 65; and state, county and city retirees under age 65. This plan moved to self-insurance in 2006. The Medicare Eligible Health Plan has been self-insured since 1992 and consists of medical and drug benefits. Medical benefits are delivered by Humana and drug benefits are delivered by Medco. The premiums in 2006 were $315, but due to a switch to a Medicare Advantage Plan and participation in Medicare Part D, the premium for 2007 decreased to $283. Medicare-eligible members pay an out-of-pocket premium per month of $93.50. Medicare subsidizes the Medicare

Advantage Plan, KTRS pays a fixed premium and the member pays 4 percent of the cost when they have a medical event. Drug benefits are delivered to members in two ways. Members may use a three-tier incentive formulary: a 20 percent generic/brand name retail co-pay; a 35 percent brand/non-formulary retail co-pay; and a $150 annual retail deductible. Members may choose a home delivery option for a 90-day supply that includes fixed co-pays: a $10 generic co-pay; a $20 brand formulary; a $35 non-formulary; and no annual deductible. KTRS has made significant efforts to contain retirement and health care costs since 1992. In 1992, KTRS went to self-insurance for retirees. In 1998, air time purchases were set up at full-actuarial cost. At the time of retirement, the actuary will determine actual cost and the member will pay the difference. In 1998, the high three at age 55 with 27 years of service has proven to be cost effective because it encourages members to work until age 55. In 2001, double dipping of medical benefits was eliminated if a member returned to work. In 2002, the medical benefit for new hires was reduced and the 100 percent benefit could only be obtained with 27 years of service. Return-to-work salaries for employees with fewer than 30 years of service (after a required breaks in service) were reduced to 65 percent of the employee's last contract salary adjusted for inflation. If an employee with 30 years or more of service returned to work (after a required break in service) an employee could return to work at a rate of 75 percent of their last salary adjusted for inflation. A limit was imposed on the number of retirees that could return to full-time employment. The benefit multiplier was reduced for new hires and the field of membership was expanded to include part-time employees. In 2004, service credit purchases were based on full-actuarial cost. As a result of the changes made in 2002, the number of employees who retired dropped from 1,535 in 2001 to 1,182 in 2006. In 2006, KTRS took advantage of Medicare Part D, which resulted in an annual savings of $10 million and in 2007 utilized Medicare Advantage Private Fee for Service for an annual savings of $11 million. KTRS was a founder of the Public Healthcare Roundtable, which was formed to address health care costs on a national level. KTRS provides a life-time retirement benefit for its members determined by the member's length of service and salary and a pay-as-you-go medical benefit. This provided school districts with the ability to attract and retain quality teachers and provides positions and promotions for current teachers. The KTRS monthly retirement annuity for pension and medical benefits is $91 million and $14 million respectively. Most of the funding for retirement benefits is derived from investment earnings.

The following questions regarding the presentation were raised:

1. Regarding Recap of Actuarial Status of the System (Page 5). Brad Cowgill asked in connection with the medical benefit for teachers, what length of time does the $4.3 billion liability represent. Mr. Harbin stated that the liabilities are determined by the benefits

assuming that single coverage would be provided for KTRS retirees and the active employees eligible to retire for the same 30-year period and at the discount rate of 7.5 percent.

2. Regarding Schedule of Employee/Employer Contribution Rates (Page 9). Secretary Crall asked how Kentucky compares to surrounding states with regard to teachers not paying social security. In the seven surrounding states, teachers in Missouri, Illinois and Ohio do not pay social security. Mr. Crall asked if the retirees in those states receive health insurance benefits. Mr. Harbin stated that in Missouri retirees receive health insurance benefits through local school districts at whatever level benefits are funded. The state of Ohio provides medical insurance for their retirees and they have prefunded medical benefits for their teachers.

3. Regarding The Average Career Educator (Page 14). Secretary Crall asked if an employee who has 27 years of service and is 49-years-old has to wait until 55 to receive to full benefit of their retirement. Mr. Harbin stated that the employee could retire at age 49, but there are incentives for them to work longer. KTRS holds mid-career and pre-retirement workshops to educate members on the benefits of working longer to sustain themselves throughout retirement. The combination of incentives and education has increased the average retirement age and the retention of teachers in the classroom. Secretary Crall asked when purchasing five years of service, do members of KRS and KTRS have to pay the full-actuarial cost. Mr. Hanes stated that when that provision was enacted, it was written in such a way that it recognized full-actuarial cost at age 65. Mr. Hanes pointed out that employees were retiring before age 65, which created a cost for the systems. Mr. Hanes stated that in the past few years, KRS changed that factor so that employees are truly paying the actual cost. Secretary Crall asked if it was safe to assume that fewer employees were purchasing time due to the changes that had been made. Mr. Harbin stated that KTRS purchase was always at full-actuarial cost so KTRS had a low number of employees who purchased air time.

4. Representative Moberly asked Mr. Hanes what was the length of time that KRS employees were able to purchase service for less than the full-actuarial cost. Mr. Hanes stated between 1998 and 2003. Representative Moberly asked if purchasing service at less than the full-actuarial cost had a serious impact on the system. Mr. Hanes stated that there was no way to track the impact. Representative Moberly asked what the factors were that caused KRS to allow people to purchase credit for less than actuarial cost. Mr. Hanes stated the actuary assumed that employees would retire at the normal retirement age of 65. Representative Moberly asked if it was KRS's responsibility to provide the actuary with the factors or should the actuary have anticipated some of the factors. Mr. Hanes stated it was the actuary's responsibility.

5. Regarding System's Funded & Unfunded Liabilities (Page 5). John Hall asked how to reconcile the unfunded liability of $4.1 billion if teachers are paying their own medical benefits. Mr. Harbin stated that teachers are not subject to the inviolable contract, which means the benefit could cease. He pointed out that teachers are currently receiving that benefit, so the state is borrowing money for the pension plan to pay that benefit for retired teachers and the unfunded liability for the retirees is being calculated. Mr. Hall confirmed that the amount retirees pay into their medical benefit does not cover the full benefit. Mr. Harbin stated that was correct.

Chairman Moberly stated that it should be emphasized that because of the lack of the presumed contractual obligation, if the medical benefits for KTRS retirees are not funded on a pay-as-you-go basis, KTRS will be obligated to cut benefits to the retirees. Mr. Harbin stated that by statute the Board of Trustees can only provide the benefit to the level of funds available, so there would be rather drastic cuts. Representative Moberly asked if monies from the pension plan could be used to pay medical benefits. Mr. Harbin stated that KTRS is statutorily prevented from using funds in the pension plan to cover the cost of medical benefits. Representative Moberly asked what dollar level KTRS would be seeking from the legislature to fund benefits. Mr. Harbin stated approximately $14 million. Representative Moberly asked what amount would be necessary to keep the benefits for KTRS employees at the current level. Mr. Harbin stated that the actuary had not projected that amount for the next biennium, but based on today's market, the amount would be approximately $100 million a year. Representative Moberly asked if KTRS was expecting Humana to provide the same discount next year. Mr. Harbin stated it was anticipated that KTRS would receive the same discount rate from Humana, but the contract provides for KTRS to be able to revert back to the previous self-insured plan.

Chairman Farris noted that no individuals signed up to make public comments.

Bob Arnold asked if he could be provided with presentation material in advance of future meetings. Chairman Farris stated that presenters would be asked to provide his office with any material prior to meetings.

Chairman Farris stated that the June meeting is scheduled for June 19, 2007 at 1:00 p.m. in Room 129. He further stated that Brad Cowgill and Sylvia Lovely will make presentations on the impact of the retirement systems on their agency's fiscal budgets. He also stated that it is anticipated that if the contract for legal services has been awarded by the next meeting and if time permits, the consultant would be available to discuss the inviolable contract. Chairman Farris noted that the July meeting is scheduled for July 23, 2007 at 1:00 p.m. in Room 129.

With no further business before the Commission, a motion was made and seconded to adjourn. Motion carried.

Respectfully submitted,

John R. Farris, Secretary
Finance and Administration Cabinet